No. 77-291

In the Supreme Court of the United States

OCTOBER TERM, 1977

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER, III

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

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Respondents rely heavily on the court of appeals' observation (Pet. App. 27A) that they had been "living in a world of customer-directed give-ups." They argue (Response to Petition 9) that the New York Stock Exchange and other national stock exchanges authorized and promoted give-ups among their members, and suggest that their conduct was indistinguishable from that of their fellow members on the New York Stock Exchange during the period in question. Their contention apparently is that for these reasons their violations of the anti-fraud provisions of the federal securities laws were neither particularly serious nor indicative of unsuitability for the securities business, and that the court of appeals therefore was justified in changing the sanction the Commission had imposed.

The "give-up" scheme in which respondents played a central role, however, was a far cry from the give-ups common during the period in question. At that time, the constitution and rules of the New York Stock Exchange required that its members charge certain fixed commission rates on transactions executed on that Exchange, and forbade rebates (Pet. App. 4A). Despite this across-the-board rule, large institutional customers, such as mutual funds, that had tremendous bargaining power became aware of the economies of scale inherent in the execution of their securities transactions, and insisted that brokers devise a method by which they could, in effect, reduce their commission charges accordingly.

In response, the practice of "give-ups" evolved, whereby an institutional customer required a member broker to transfer a portion of the commission payments it received for Exchange transactions to another member broker who had been uninvolved in the particular transaction in which this commission had been earned, but who had performed some other service for that institutional customer.[1] See Securities and Exchange Commission Report to Congress on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 162-163, 169-172 (1966). The Exchange's fixed commission schedule was technically preserved by the give-up device, since the fixed rate was charged and never returned to the customer. But the institutional customer was able to take economic advantage of its bargaining power by transferring a portion of its commission payments to third persons in return for services they had performed for the institutional investor that were unrelated to the transaction on which the commission arose.

[1]Typically, the member broker which received the give-up was engaged in the distribution of the institutional customer's shares to the public.

The transactions in this case, however, took place in the over-the-counter market,[2] where there was no fixed commission schedule[3] that might arguably have provided either an economic—or legal—justification for give-ups.

Even more importantly, the give-up scheme in which respondents played such a critical role was not a device designed to confer an indirect benefit on the mutual funds by permitting them to direct that part of the commission fees they paid be transferred in turn to third persons to whom the funds owed some unrelated financial obligation. Instead, the give-ups here were used to defraud the funds by enabling IOS, the manager of an investment funds, "simply to pocket give-ups which [it] ha[d] diverted to [it]self" (Pet. App. 12A). Respondent Lipper Corp. knowingly assisted this scheme by charging its customers, the IOS-affiliated mutual funds, a commission which apparently far exceeded respondent's cost of executing the funds' transactions at a reasonable profit, and then diverting 50 percent of those commissions to IOS itself.

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[2]Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading. * * * [A]ll registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience and function; the securities differ in price, quality and activity.

Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2, 541 (1963).

[3]When Congress amended the Securities Exchange Act in 1938, it expressly prohibited national securities associations, such as the National Association of Securities Dealers (the self-regulatory entity performing the same initial oversight function for the over-the-counter market that the exchanges perform for the exchange markets) from fixing commission rates in any way. See Section 15A(b)(6) of the Securities Exchange Act, as added, 52 Stat. 1070, and amended, 15 U.S.C. 78*o*-3(b)(6).

Respondents' entire effort to analogize these payments to exchange give-ups is an attempt to cloak with an air of legitimacy a scheme to kick-back to a fiduciary monies diverted from those to whom the fiduciary owed a special obligation of trust and confidence. As the court of appeals expressly noted, "there was nothing in all this that should have induced a belief that give-ups could be utilized for the benefit of the adviser rather than of the fund" (Pet. App. 27A).

Although respondents assert that the court "recogniz[ed] the universal application by NYSE members of charging the NYSE minimum commission rates on over-the-counter agency transactions" (Response to Petition 10-11), the court of appeals concluded that respondents' "prevailing practice argument [was] considerably overstated" (Pet. App. 22A), and emphasized the crucial distinction between respondents' conduct and other instances where there had been give-ups on over-the-counter transactions. While other brokerage firms had provided give-ups—at IOS's direction—to its subsidiary Investors Planning Corporation (IPC), the court found that nothing in the record indicated that those firms were aware that IOS owned 80 percent of IPC, or that IPC had performed no services in return for the monies channeled to it (*ibid.*). Thus no other firms were shown to have knowingly and systematically assisted IOS's use of give-ups not to confer any benefit—direct or indirect—on the mutual funds, but instead to line the pockets of the funds' investment adviser, IOS, at the funds' expense. Indeed, Lipper Corp. was formed for the very purpose of serving as IOS's link to the American securities market and carrying out this scheme (Pet. App. 4A).

The court of appeals affirmed the Commission's conclusion that respondents' payments to IOS constituted serious violations of the federal securities laws. The only question presented in this petition is whether the court of appeals could nevertheless substitute its judgment regarding the sanction that the public interest requires for that of the Commission. For the reasons stated in the petition, the court exceeded the proper scope of judicial review in doing so.

Respectfully submitted.

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